

and processing plant relationship. Natural gas liquids (NGL's) shall be considered as one product.

(c)(1) Except as provided in paragraph (d)(2) of this section, the processing allowance shall not be applied against the value of the residue gas. Where there is no residue gas ONRR may designate an appropriate gas plant product against which no allowance may be applied.

(2) Except as provided in paragraph (c)(3) of this section, the processing allowance deduction on the basis of an individual product shall not exceed 66% percent of the value of each gas plant product determined in accordance with § 1206.153 of this subpart (such value to be reduced first for any transportation allowances related to postprocessing transportation authorized by § 1206.156 of this subpart).

(3) Upon request of a lessee, ONRR may approve a processing allowance in excess of the limitation prescribed by paragraph (c)(2) of this section. The lessee must demonstrate that the processing costs incurred in excess of the limitation prescribed in paragraph (c)(2) of this section were reasonable, actual, and necessary. An application for exception (using Form MMS-4393, Request to Exceed Regulatory Allowance Limitation) shall contain all relevant and supporting documentation for ONRR to make a determination. Under no circumstances shall the value for royalty purposes of any gas plant product be reduced to zero.

(d)(1) Except as provided in paragraph (d)(2) of this section, no processing cost deduction shall be allowed for the costs of placing lease products in marketable condition, including dehydration, separation, compression, or storage, even if those functions are performed off the lease or at a processing plant. Where gas is processed for the removal of acid gases, commonly referred to as "sweetening," no processing cost deduction shall be allowed for such costs unless the acid gases removed are further processed into a gas plant product. In such event, the lessee shall be eligible for a processing allowance as determined in accordance with this subpart. However, ONRR will not grant any processing allowance for

processing lease production which is not royalty bearing.

(2)(i) If the lessee incurs extraordinary costs for processing gas production from a gas production operation, it may apply to ONRR for an allowance for those costs which shall be in addition to any other processing allowance to which the lessee is entitled pursuant to this section. Such an allowance may be granted only if the lessee can demonstrate that the costs are, by reference to standard industry conditions and practice, extraordinary, unusual, or unconventional.

(ii) Prior ONRR approval to continue an extraordinary processing cost allowance is not required. However, to retain the authority to deduct the allowance the lessee must report the deduction to ONRR in a form and manner prescribed by ONRR.

(e) If ONRR determines that a lessee has improperly determined a processing allowance authorized by this subpart, then the lessee must pay any additional royalties, plus interest determined under § 1218.54 of this chapter, or will be entitled to a credit with interest. If the lessee takes a deduction for processing on Form MMS-2014 by improperly netting the allowance against the sales value of the gas plant products instead of reporting the allowance as a separate entry, ONRR may assess a civil penalty under 30 CFR part 1241.

[53 FR 1272, Jan. 15, 1988, as amended at 61 FR 5466, Feb. 12, 1996; 64 FR 43288, Aug. 10, 1999; 73 FR 15891, Mar. 26, 2008]

#### § 1206.159 Determination of processing allowances.

(a) *Arm's-length processing contracts.*

(1)(i) For processing costs incurred by a lessee under an arm's-length contract, the processing allowance shall be the reasonable actual costs incurred by the lessee for processing the gas under that contract, except as provided in paragraphs (a)(1)(ii) and (a)(1)(iii) of this section, subject to monitoring, review, audit, and adjustment. The lessee shall have the burden of demonstrating that its contract is arm's-length. ONRR' prior approval is not required before a lessee may deduct costs incurred under an arm's-length contract. The lessee must claim a processing allowance by

reporting it as a separate entry on the Form MMS-2014.

(ii) In conducting reviews and audits, ONRR will examine whether the contract reflects more than the consideration actually transferred either directly or indirectly from the lessee to the processor for the processing. If the contract reflects more than the total consideration, then the ONRR may require that the processing allowance be determined in accordance with paragraph (b) of this section.

(iii) If ONRR determines that the consideration paid pursuant to an arm's-length processing contract does not reflect the reasonable value of the processing because of misconduct by or between the contracting parties, or because the lessee otherwise has breached its duty to the lessor to market the production for the mutual benefit of the lessee and lessor, then ONRR shall require that the processing allowance be determined in accordance with paragraph (b) of this section. When ONRR determines that the value of the processing may be unreasonable, ONRR will notify the lessee and give the lessee an opportunity to provide written information justifying the lessee's processing costs.

(2) If an arm's-length processing contract includes more than one gas plant product and the processing costs attributable to each product can be determined from the contract, then the processing costs for each gas plant product shall be determined in accordance with the contract. No allowance may be taken for the costs of processing lease production which is not royalty-bearing.

(3) If an arm's-length processing contract includes more than one gas plant product and the processing costs attributable to each product cannot be determined from the contract, the lessee shall propose an allocation procedure to ONRR. The lessee may use its proposed allocation procedure until ONRR issues its determination. The lessee shall submit all relevant data to support its proposal. ONRR shall then determine the processing allowance based upon the lessee's proposal and any additional information ONRR deems necessary. No processing allowance will be granted for the costs of

processing lease production which is not royalty bearing. The lessee must submit the allocation proposal within 3 months of claiming the allocated deduction on Form MMS-2014.

(4) Where the lessee's payments for processing under an arm's-length contract are not based on a dollar per unit basis, the lessee shall convert whatever consideration is paid to a dollar value equivalent for the purposes of this section.

(b) *Non-arm's-length or no contract.* (1) If a lessee has a non-arm's-length processing contract or has no contract, including those situations where the lessee performs processing for itself, the processing allowance will be based upon the lessee's reasonable actual costs as provided in this paragraph. All processing allowances deducted under a non-arm's-length or no-contract situation are subject to monitoring, review, audit, and adjustment. The lessee must claim a processing allowance by reflecting it as a separate entry on the Form MMS-2014. When necessary or appropriate, ONRR may direct a lessee to modify its estimated or actual processing allowance.

(2) The processing allowance for non-arm's-length or no-contract situations shall be based upon the lessee's actual costs for processing during the reporting period, including operating and maintenance expenses, overhead, and either depreciation and a return on undepreciated capital investment in accordance with paragraph (b)(2)(iv)(A) of this section, or a cost equal to the initial depreciable investment in the processing plant multiplied by a rate of return in accordance with paragraph (b)(2)(iv)(B) of this section. Allowable capital costs are generally those costs for depreciable fixed assets (including costs of delivery and installation of capital equipment) which are an integral part of the processing plant.

(i) Allowable operating expenses include: Operations supervision and engineering; operations labor; fuel; utilities; materials; ad valorem property taxes; rent; supplies; and any other directly allocable and attributable operating expense which the lessee can document.

(ii) Allowable maintenance expenses include: Maintenance of the processing

plant; maintenance of equipment; maintenance labor; and other directly allocable and attributable maintenance expenses which the lessee can document.

(iii) Overhead directly attributable and allocable to the operation and maintenance of the processing plant is an allowable expense. State and Federal income taxes and severance taxes, including royalties, are not allowable expenses.

(iv) A lessee may use either depreciation or a return on depreciable capital investment. When a lessee has elected to use either method for a processing plant, the lessee may not later elect to change to the other alternative without approval of the ONRR.

(A) To compute depreciation, the lessee may elect to use either a straight-line depreciation method based on the life of equipment or on the life of the reserves which the processing plant services, or a unit-of-production method. After an election is made, the lessee may not change methods without ONRR approval. A change in ownership of a processing plant shall not alter the depreciation schedule established by the original processor/lessee for purposes of the allowance calculation. With or without a change in ownership, a processing plant shall be depreciated only once. Equipment shall not be depreciated below a reasonable salvage value.

(B) The ONRR shall allow as a cost an amount equal to the allowable initial capital investment in the processing plant multiplied by the rate of return determined pursuant to paragraph (b)(2)(v) of this section. No allowance shall be provided for depreciation. This alternative shall apply only to plants first placed in service after March 1, 1988.

(v) The rate of return must be the industrial rate associated with Standard and Poor's BBB rating. The rate of return must be the monthly average rate as published in Standard and Poor's Bond Guide for the first month for which the allowance is applicable. The rate must be redetermined at the beginning of each subsequent calendar year.

(3) The processing allowance for each gas plant product shall be determined

based on the lessee's reasonable and actual cost of processing the gas. Allocation of costs to each gas plant product shall be based upon generally accepted accounting principles. The lessee may not take an allowance for the costs of processing lease production which is not royalty bearing.

(4) A lessee may apply to ONRR for an exception from the requirement that it compute actual costs in accordance with paragraphs (b)(1) through (b)(3) of this section. The ONRR may grant the exception only if: (i) The lessee has arm's-length contracts for processing other gas production at the same processing plant; and (ii) at least 50 percent of the gas processed annually at the plant is processed pursuant to arm's-length processing contracts; if the ONRR grants the exception, the lessee shall use as its processing allowance the volume weighted average prices charged other persons pursuant to arm's-length contracts for processing at the same plant.

(c) *Reporting requirements*—(1) *Arm's-length contracts*. (i) The lessee must notify ONRR of an allowance based on incurred costs by using a separate entry on the Form MMS-2014.

(ii) ONRR may require that a lessee submit arm's-length processing contracts and related documents. Documents shall be submitted within a reasonable time, as determined by ONRR.

(2) *Non-arm's-length or no contract*. (i) The lessee must notify ONRR of an allowance based on the incurred costs by using a separate entry on the Form MMS-2014.

(ii) For new processing plants, the lessee's initial deduction shall include estimates of the allowable gas processing costs for the applicable period. Cost estimates shall be based upon the most recently available operations data for the plant or, if such data are not available, the lessee shall use estimates based upon industry data for similar gas processing plants.

(iii) Upon request by ONRR, the lessee shall submit all data used to prepare the allowance deduction. The data shall be provided within a reasonable period of time, as determined by ONRR.

(iv) If the lessee is authorized to use the volume weighted average prices

charged other persons as its processing allowance in accordance with paragraph (b)(4) of this section, it shall follow the reporting requirements of paragraph (c)(1) of this section.

(d) *Interest.* (1) If a lessee deducts a processing allowance on its Form MMS-2014 that exceeds 66⅔ percent of the value of the gas processed without obtaining prior approval of ONRR under § 1206.158, the lessee shall pay interest on the excess allowance amount taken from the date such amount is taken to the date the lessee files an exception request with ONRR.

(2) If a lessee erroneously reports a processing allowance which results in an underpayment of royalties, interest shall be paid on the amount of that underpayment.

(3) Interest required to be paid by this section shall be determined in accordance with § 1218.54 of this chapter.

(e) *Adjustments.* (1) If the actual processing allowance is less than the amount the lessee has taken on Form MMS-2014 for each month during the allowance reporting period, the lessee shall pay additional royalties due plus interest computed under § 1218.54 of this chapter from the allowance reporting period when the lessee took the deduction to the date the lessee repays the difference to ONRR. If the actual processing allowance is greater than the amount the lessee has taken on Form MMS-2014 for each month during the allowance reporting period, the lessee shall be entitled to a credit with interest.

(2) For lessees processing production from onshore Federal leases, the lessee must submit a corrected Form MMS-2014 to reflect actual costs, together with any payment, in accordance with instructions provided by ONRR.

(3) For lessees processing gas production from leases on the OCS, if the lessee's estimated processing allowance exceeds the allowance based on actual costs, the lessee must submit a corrected Form MMS-2014 to reflect actual costs, together with its payment, in accordance with instructions provided by ONRR. If the lessee's estimated costs were less than the actual costs, the refund procedure will be specified by ONRR.

(f) *Other processing cost determinations.* The provisions of this section shall apply to determine processing costs when establishing value using a net back valuation procedure or any other procedure that requires deduction of processing costs.

[53 FR 1272, Jan. 15, 1988, as amended at 53 FR 45762, Nov. 14, 1988; 61 FR 5466, Feb. 12, 1996; 64 FR 43288, Aug. 10, 1999; 73 FR 15891, Mar. 26, 2008]

#### § 1206.160 Operating allowances.

Notwithstanding any other provisions in these regulations, an operating allowance may be used for the purpose of computing payment obligations when specified in the notice of sale and the lease. The allowance amount or formula shall be specified in the notice of sale and in the lease agreement.

[61 FR 3804, Feb. 2, 1996]

### Subpart E—Indian Gas

SOURCE: 64 FR 43515, Aug. 10, 1999, unless otherwise noted.

#### § 1206.170 What does this subpart contain?

This subpart contains royalty valuation provisions applicable to Indian lessees.

(a) This subpart applies to all gas production from Indian (tribal and allotted) oil and gas leases (except leases on the Osage Indian Reservation). The purpose of this subpart is to establish the value of production for royalty purposes consistent with the mineral leasing laws, other applicable laws, and lease terms. This subpart does not apply to Federal leases.

(b) If the specific provisions of any Federal statute, treaty, negotiated agreement, settlement agreement resulting from any administrative or judicial proceeding, or Indian oil and gas lease are inconsistent with any regulation in this subpart, then the Federal statute, treaty, negotiated agreement, settlement agreement, or lease will govern to the extent of that inconsistency.

(c) You may calculate the value of production for royalty purposes under methods other than those the regulations in this title require, but only if